APPENDIX B. OPTIONS TO INCREASE TAX REVENUES

APPENDIX C. ASSUMPTIONS USED IN NATIONAL DEFENSE PROJECTIONS--QUANTITIES OF WEAPONS PROCURED UNDER CBO BASELINE, POSSIBLE ADMINISTRATION PROGRAM, AND ALTERNATIVE

CHAPTER I. INTRODUCTION

The federal deficit in fiscal year 1981 was about $58 billion. The Congressional Budget Office (CBO) estimates that, if current policies were continued unchanged, this total would rise to $109 billion in 1982, $188 billion in 1984, and as much as $248 billion in 1987. Such a substantial increase would raise the deficit as a percentage of gross national product (GNP) from 2 percent in 1981 to approximately 5 percent between 1984 and 1987. If this prospective growth in the federal budget deficit were principally a cyclical phenomenon, it would be cause for little concern. Indeed, rising budget deficits during periods of recession help to counteract declines in economic activity. Unfortunately, however, the budget problem facing the Congress is not a cyclical one. Instead, without significant legislative changes in federal spending or taxing policies, large budget deficits will continue indefinitely.

The prospect of growing deficits represents a major departure from previous CBO baseline budget projections, in which revenues grew faster than outlays and the budget began to show a surplus within two or three years. The surplus in those projections was caused by revenues' increasing more rapidly than GNP as inflation and economic growth pushed taxpayers into higher income tax brackets. Outlays, on the other hand, grew more slowly because most spending was assumed merely to keep pace with inflation.

During its second session, the 97th Congress will be debating various proposals to reduce these large deficits. This report discusses alternative strategies for cutting spending; it also analyzes specific options for each of the major program areas in the budget. In addition, the report examines a broad range of alternative tax increases, as well as some options to lower the level of federal credit outstanding.

PLAN OF THE REPORT

Chapter II discusses CBO's baseline budget projections. It sets forth broad strategies that could be used to reduce spending in the areas of defense, benefit payments to individuals, grants-in-aid to state and local governments, and other federal expenditures. Finally, it describes certain issues that should be considered in making budget and tax decisions.

Chapters III through XI detail the broad reduction strategies for each major budget function. Under each strategy, specific options are outlined, together with estimates of potential savings and some of the major programmatic effects. Most of the specific budget options are cross-referenced to Appendix A, where additional budget and program information are given. (Appendix A also presents a number of options that do not fall under any one of the broad strategies outlined in the text chapters.)

Chapter XII discusses options for raising revenues, ranging from postponing some of the income tax reductions now scheduled to introducing new consumption or value-added taxes. It also outlines incremental adjustments to the current tax system, such as eliminating certain tax expenditures. These are treated more fully in Appendix B. Possible new taxes, on items such as natural gas and oil imports, are also briefly discussed in this chapter, along with options for changing excise taxes.

Chapter XIII outlines ways to reduce the amount of federal credit outstanding. Not only do large federal deficits have an impact on financial markets; the fact that the federal government reallocates capital by its loans and loan guarantees also has an impact. For this reason, as well as the fact that credit programs are often viewed as substitutes for spending programs, credit options should be included in a report on reducing the overall federal deficit. Some options would generate outlay reductions, while others would merely lessen the degree of federal intervention in financial markets.

CHAPTER II. BASELINE PROJECTIONS AND BUDGET STRATEGIES

This chapter summarizes the Congressional Budget Office baseline budget projections used to estimate the effects of the budget and tax changes discussed in this report. It also highlights strategies that could be followed to reduce budget deficits over the next five years. (Each of the broad strategies is developed more fully in the subsequent chapters.) Finally, it surveys some of the economic and administrative issues that should be considered in reaching budget and tax decisions.

THE CBO BASELINE PROJECTIONS

The budget projections are intended to provide a baseline from which to measure the effects of tax and budget changes. They indicate the likely course of federal spending and revenues if present policies were continued and if the economy performed according to certain assumptions. The projections are not, therefore, a forecast of actual budget outcomes. The economic assumptions underlying the projections are given in Table II-1. 1/

Outlays

Federal outlays are projected to increase from $740 billion in 1982 to $1.1 trillion in 1987 (see Table II-2). The largest dollar increase is in benefit payments, which include payments for retired and disabled workers and their dependents and survivors, unemployed workers, veterans, students, low-income families and individuals, and also health-care benefits provided under Medicare and Medicaid. Total funding for these payments is projected to rise from $351 billion in 1982 to $533 billion in 1987. National defense accounts

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1. A more detailed presentation of the CBO's baseline projections and underlying economic assumptions is given in the two other volumes of this three-part report to the Senate and House Committees on the Budget. See Congressional Budget Office, Part I, The Prospects for Economic Recovery (February 1982), and Part II, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982).

for the next largest increase, projected to grow from $190 billion in 1982 to $303 billion in 1987. Net interest costs are projected approximately to double, from $85 billion to $168 billion. The remaining two categories of federal spending are projected to increase only slightly, with grants to state and local governments rising from $49 billion to $57 billion, and other federal operations from $64 billion to $69 billion. Altogether, outlays are projected to grow about one percentage point less than the assumed growth in the gross national product. Consequently, as a percentage of GNP, outlays are projected to decline from 24.2 percent in 1982 to 22.7 percent in 1987.

TABLE II-1. BASELINE ECONOMIC ASSUMPTIONS (By calendar year, dollar amounts in billions)

	Actual	Forecast		Longer-Term Assumptions a/			
	1981	1982	1983	1984	1985	1986	1987
Gross National Product (GNP)							
Current dollars							
Amount	2,922	3,140	3,515	3,882	4,259	4,659	5,083
Percent change, year to year	11.3	7.5	11.9	10.4	9.7	9.4	9.1
Constant (1972) dollars							
Amount	1,510	1,509	1,574	1,632	1,689	1,748	1,809
Percent change, year to year	1.9	-0.1 b/	4.4	3.6	3.5	3.5	3.5
Prices							
GNP deflator (percent change, year to year)	9.1	7.5	7.3	6.6	6.0	5.7	5.4
Consumer Price Index (percent change, year to year)	10.3	7.5	6.9	6.9	6.4	6.0	5.7
Unemployment Rate (percent, annual average)	7.6	8.9	8.0	7.4	7.2	6.9	6.7
Interest Rate (91-day Treasury bills, percent, annual average)	14.0	12.0	13.2	11.3	9.4	8.7	8.1

a. The figures for 1982 and 1983 are taken from CBO's economic forecast for those years. The figures for the 1984-1987 period are not forecasts; rather, they are assumptions of moderate noncyclical growth with sustained progress in reducing inflation and unemployment. It is uncertain whether the economic progress assumed in these projections can be attained with the prospective trend of money growth and without the enactment of further spending cuts or tax increases to reduce the deficit.

a. Minus sign denotes a negative growth rate.

TABLE II-2. BASELINE OUTLAY PROJECTIONS FOR MAJOR PROGRAM CATEGORIES (By fiscal year, in billions of dollars)

	Actual 1981	Estimated 1982	Baseline Projection 1983	1984	1985	1986	1987
National Defense a/	160	190	214	238	263	286	303
Benefit Payments for Individuals b/	320	351	383	413	452	490	533
Grants to State and Local Governments c/	55	49	48	49	51	54	57
Net Interest	69	85	106	130	143	156	168
Other Federal Operations	57	64	58	59	62	67	69
Total	661	740	809	889	971	1,052	1,130

NOTE: Details may not add to totals because of rounding.

a. Includes benefit payments for retired military personnel.

b. Some grants to state and local governments go toward such benefit payments as Medicaid and Aid to Families with Dependent Children. These grants are classified here as benefit payments for individuals.

c. This category covers grants for purposes such as general revenue sharing, highway construction, community development, and employment and training assistance. It does not include grants for benefit payments.

Not only do these projections depend upon the underlying economic assumptions; in some cases, they depend on specific assumptions regarding adjustments for inflation. For all non-defense discretionary appropriation accounts, it is assumed that funding levels are maintained in constant terms over the projection period unless they are specifically capped by authorization levels.

For defense, the baseline projections reflect the explicit programs proposed by the Administration, as amended for fiscal year 1982 by Congressional action and adjusted for the outyears by CBO according to its interpretation of Congressional intent. Under these assumptions, defense budget authority rises (in real terms) by about 4.5 percent in 1983, by 2.2 percent in 1984, and declines slightly thereafter. An alternative defense baseline is also discussed in Chapter III, in which budget authority is assumed to increase (in real terms) approximately 6.2 percent in 1983 and 7 percent thereafter. Under this assumption, outlays for defense would be higher than the CBO baseline projection by $1 billion in 1983, by $7 billion in 1984, and by $70 billion in 1987. This would increase total projected outlays to $810 billion in 1983 and $1.2 trillion in 1987.

Revenues

Under current tax laws, revenues are projected to grow by less than 7 percent a year during the next five years, from $631 billion in 1982 to $882 billion in 1987 (see Table II-3). This substantial slowing in the growth of revenues results primarily from the major tax changes embodied in the Economic Recovery Tax Act of 1981. The share of corporate and personal income taxes decreases over the projection period, while the social insurance share of taxes increases.

Deficits

These outlay and revenue projections result in large and growing budget deficits, increasing from $109 billion in 1982 to $188 billion in 1984 and $248 billion in 1987 (see Table II-4). As a percentage of GNP, deficits increase from 2 percent in 1981 to approximately 5 percent in 1985, 1986, and 1987. If a 7 percent annual real growth in budget authority for defense is assumed, the deficit in 1987 increases to $318 billion. Off-budget outlays add another $19 billion to the federal deficit in 1983 and $22 billion in 1987.

BUDGET STRATEGIES

As the above projections show, the size of the federal deficit is projected to be significant in 1983 and to continue growing through 1987. Both the projected magnitude of the deficit and the

TABLE II-3. BASELINE REVENUE PROJECTIONS BY SOURCE (By fiscal year, in billions of dollars)

	Actual 1981	Estimated 1982	Baseline Projection 1983	1984	1985	1986	1987
Individual Income Taxes	285.6	300	303	316	344	367	396
Corporate Income Taxes	61.1	50	51	62	63	64	73
Social Insurance Taxes	186.4	209	227	250	282	313	339
Excise Taxes							
Windfall profit taxes	23.3	23	21	21	20	20	20
Other excise taxes	17.5	18	19	20	16	16	16
Estate and Gift Taxes	6.8	7	6	6	5	5	4
Customs Duties	8.1	9	9	9	10	10	10
Miscellaneous Revenues	13.8	15	16	18	19	19	19
Total Current Law Revenues	602.6	631	652	701	759	814	877
Extension of Highway Trust Fund Taxes	---	---	---	---	4	4	4
Total Baseline Revenues	602.6	631	652	701	763	818	882

NOTE: Details may not add to totals because of rounding.

limited flexibility to reduce outlays in the near term demonstrate the severity of the problem facing the Congress.

To achieve lower deficits will require further reductions in the growth of federal spending and/or significant tax increases. For example, to hold the budget deficit at the 1981 level of 2 percent of GNP in 1987 would mean limiting the deficit to approximately $100 billion in that year. To do this would require some combination of spending reductions and tax increases that would total $148 billion in 1987.

If the lower deficits were to be achieved solely through spending reductions, total outlays over the next five years would have to be held to an average growth rate of less than 6 percent per year--about three percentage points below the projected growth

TABLE II-4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	Actual 1981	Estimated 1982	Projections 1983	1984	1985	1986	1987
	(In Billions of Dollars)						
Baseline Revenues	603	631	652	701	763	818	882
Baseline Outlays	660	740	809	889	971	1,052	1,130
Baseline Unified Budget Deficit	58	109	157	188	208	234	248
Outlays of Off-Budget Federal Entities	21	20	19	18	18	20	22
Total Deficit	79	129	176	206	226	254	270
Baseline Budget Authority	716	771	863	948	1,037	1,114	1,191
	(As a Percent of GNP)						
Baseline Revenues	21.1	20.6	19.0	18.5	18.3	18.0	17.7
Baseline Outlays	23.1	24.2	23.6	23.5	23.3	23.1	22.7
Baseline Unified Budget Deficit	2.0	3.6	4.6	5.0	5.0	5.1	5.0
Outlays of Off-Budget Federal Entities	0.7	0.7	0.6	0.5	0.4	0.4	0.4
Total Deficit	2.7	4.2	5.1	5.4	5.4	5.6	5.4

of baseline outlays. If these outlay reductions were concentrated in national defense programs and benefit payments for individuals--which account for three-fourths of the projected increase in baseline outlays--1987 outlays for these purposes would have to be reduced by almost 18 percent below baseline levels. This would mean a $54 billion reduction in national defense outlays from the 1987 baseline level and a $94 billion reduction in benefit payments. It would not permit any real growth in defense outlays between 1982 and 1987, and it would cut the projected growth in benefit payments by half or more.

Reductions in defense spending of this order of magnitude, however, are very difficult to achieve because of the lag that occurs between reductions in appropriations and reductions in outlays. In Social Security and other programs under which benefits are raised automatically for increases in the Consumer Price Index (CPI), substantial short-run savings could be obtained by adjusting the indexing provisions. Such changes would not be sufficient, however, to reduce benefit payments by 18 percent below the projected 1987 baseline levels. To achieve savings of this magnitude, substantial further reductions in real benefit levels would be required.

An alternative approach would be to concentrate the necessary spending reductions on grants to state and local governments (other than for benefit payments) and other federal activities. As shown in Table II-2, however, these two budget categories are relatively small, and together, they are projected to total $127 billion by 1987 under CBO's baseline assumptions. 2/ Consequently, eliminating all such federally assisted activities (which include all natural resources, transportation, community and economic development, and most environmental and scientific programs) would still leave a deficit of well over $100 billion in 1987.

If, on the other hand, the deficit reductions were to be achieved solely on the revenue side, individual income taxes would have to be increased by 37 percent from the projected baseline level in 1987, or some major changes would have to be made in other taxes.

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2. The $127 billion total represents net outlays after subtracting projected receipts for sales of leases on Outer Continental Shelf Lands and other purposes.

Outlay Strategies

A number of broad strategies for reducing projected outlays are outlined on the following pages.

Benefit Payments for Individuals. As stated above, this category of spending--by far the largest--is projected to increase from $351 billion in 1982 to $533 billion in 1987. Much of the recent growth in benefit payments resulted from increases in benefit levels legislated during the early 1970s, automatic indexing of various cash benefits to the CPI, and rapidly rising health-care costs (see Chapters IX, X, and XI for detailed discussion).

Outlay reductions in this category could be achieved by either reducing benefits across the board or targeting the reductions toward those recipients deemed least needy. Across-the-board changes could entail limiting the automatic indexation of benefits, thereby controlling future outlays. One example, which could be implemented quickly, would be a lowering of the cost-of-living adjustment (COLA) for Social Security from 100 percent of the change in the CPI increase to two-thirds, reducing outlays by $26 billion annually by 1987. A targeted change would be to postpone the elimination of the earnings test for Social Security beneficiaries aged 70-71, now scheduled for July 1983, to 1988 or beyond. Annual savings would rise to $690 million in 1987.

Similar choices are available in Medicare. Net benefits could be cut across the board by raising the premium for Part B (physician) coverage or by raising the coinsurance payment for hospital services. By 1987, these two changes would yield annual federal savings of $3.7 billion and $1.9 billion, respectively. Alternatively, the premium or coinsurance increase could be made larger but limited to persons with incomes above a certain threshold.

In veterans' compensation, benefits could be reduced across the board by setting the COLA at less than the full increase in the CPI. Benefits could also be targeted by reducing them for beneficiaries who are less than 30 percent disabled. Since those with lesser disabilities have less impaired earnings abilities, this option would redirect the remaining benefits to those who need them most. Savings in 1987 would amount to $1.6 billion.

Defense. Defense spending is projected to increase from $190 billion in 1982 to $303 billion in 1987 under the CBO baseline assumptions. If budget authority in this area were to continue to increase by about 7 percent annually in real terms over the projection period, outlays could total $373 billion in 1987.

A number of options could reduce the rate of growth in defense spending (see Chapter III for detailed discussion). Although they would also reduce the buildup of defense capability, some strategies could minimize this effect. One would be to alter the pace of modernizing the strategic nuclear forces. For example, the Congress could cancel procurement of the B-1 bomber and expedite development of a new bomber with the "stealth" technology, while increasing the number of existing B-52 bombers on ready alert. Together, the strategic options discussed in Chapter III could reduce defense budget authority by a total of about $29 billion over the next five years; outlays would be reduced by $23 billion over the period.

Another strategy would concentrate spending for procurement of conventional forces on weapon systems designed primarily for Third World contingencies. Still another would seek alternative methods to accomplish defense missions, such as using battleships in some Navy battle groups in place of aircraft carriers, substituting improved versions of the existing armored personnel carrier for the new infantry fighting vehicle, and buying an alternative mix of aircraft for the Navy. These and other initiatives in the area of conventional forces could reduce defense budget authority over the next five years by a total of about $28 billion. Outlays would be reduced by only about $14 billion over the same period.

Finally, the Congress could seek additional efficiencies in defense pay and support costs. Examples include changes in the COLA formula for retirees and further consolidation of military bases. These and other actions could reduce defense budget authority and outlays by a total of about $7 billion over the next five years. Improvements in the defense acquisition process--for example, promoting competition through more frequent use of two or more producers to manufacture a given weapon system--could also cut costs substantially, though the precise amounts are difficult to estimate.

If all of the above-mentioned options were implemented, defense outlays could be reduced about $15 billion in 1987 and by a total of approximately $44 billion over the 1983-1987 period.

Near-term reductions in defense outlays are difficult to achieve because of the long lag that occurs between obligations and actual outlays. For example, the options outlined in Chapter III would altogether result in budget authority reductions of $14 billion in 1983 but only $1 billion in outlays for that year.

Grants to State and Local Governments. Grants to state and local governments are projected to increase from $49 million in

1982 to $57 million in 1987. They could be reduced through two general approaches (see Chapters VII and VIII for more detailed discussion). 3/ First, the Congress could cut grants for the least needy jurisdictions, focusing assistance on those governments that are least able to provide for themselves. Second, federal aid could be reduced across the board by ending less effective programs or by consolidating existing categorical grants into more general-purpose block grants. Such consolidations could be applied to nutrition programs, capital grants for transportation and community and economic development, and education programs.

Numerous opportunities exist for further targeting federal grants to state and local governments. For example, Community Development Block Grants (CDBGs), Urban Development Action Grants (UDAGs) or mass transit grants could be withdrawn from jurisdictions thought to have the capacity to finance such activities themselves. Alternatively, total spending could be reduced and distributed so as to provide greater per capita amounts to distressed areas and lesser amounts to areas with larger tax bases. Similarly, the General Revenue Sharing program, which provides largely unrestricted fiscal assistance to all general-purpose local governments, could be further targeted by eliminating eligibility of localities with above-average fiscal capacities. Alternatively, portions of present federal programs that are not directed toward special needs could be eliminated--for example, that portion of vocational education grants not restricted to serving disadvantaged students.

Under the grant-consolidation approach, the intent would be to increase the efficiency and effectiveness with which recipient governments spend assistance monies by allowing them more flexibility. This would, however, risk diminishing the degree to which states and localities use their grants to pursue national policy objectives.

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3. Federal grants to state and local governments include funds provided to help support activities for which those governments are often considered primarily responsible. Grants are also provided for assistance payments for individuals (such as Medicaid and Aid to Families with Dependent Children); in these cases, the federal funds fully earmarked for specific individuals merely pass through other levels of government. This section discusses only nonindividual-assistance grants. Individual assistance grants are dealt with elsewhere.

The nutrition programs offer opportunities for increased efficiency through consolidation. At present, the nine major federal nutrition programs use at least 37 different reimbursement schemes. A block grant to the states would simplify administration, enhance state and local flexibility, and possibly permit some federal savings without diminishing nutrition assistance. On the other hand, the achievement of substantial federal savings would require the states either to cut nutrition assistance or to replace from their own resources some of the lost federal funding. The states could protect benefits for the poorest participants by ending subsidies for less needy ones, although this change alone would not compensate for loss of federal funds. Further, if some nutrition programs were forced to close because they had too few participants, the poorest would be adversely affected.

A number of capital grants that are used to maintain, replace, and develop state and local infrastructure could be combined into one large grant the use of which could be restricted to infrastructure development and, possibly, to maintenance. Such a grant could combine CDBGs, mass transit operating and capital grants, economic development grants, portions of highway funds--perhaps even the Environmental Protection Agency (EPA) wastewater treatment grants. If such grants were combined and the federal funding reduced by 20 percent, budget savings of approximately $2.6 billion would be possible in 1987.

As a final example, the now untargeted portion of state vocational education grants could be folded into the recently created elementary and secondary education block grant, and its total funding could be reduced. Again, though, this could result in cuts in the types and extent of services provided.

<u>Other Federal Operations</u>. This spending category, which includes international affairs, some transportation, agriculture, energy, natural resources, science, and similar programs, is projected to increase from $64 billion in 1982 to $69 billion in 1987. Two strategies could be applied to these programs: charging market prices, or at least full costs, for the goods and services the government provides, and reducing subsidies to the private sector.

Market or Full-Cost Pricing: The federal government provides many products and services to individuals and businesses at prices below market values and often below government costs. These implicit subsidies result in inefficient allocation and possible overuse of resources. Federal subsidies may be appropriate if the overall public benefits of a given activity are greater than the private benefits. But this is rarely the case. In most instances, in which beneficiaries are clearly identifiable and public benefits do not justify federal subsidies, the government should charge the market price of the activity or good, or at least recover its costs if there is no discernible market price. Many of the specific options that fall under this strategy would reduce outlays in the various programs since they would raise offsetting receipts. Some options, however, would increase general revenues. Either way, they would lower the deficit.

In the transportation area, the federal government could recover a higher proportion of its costs from users or beneficiaries (see Chapter VII). During 1981, the fees levied on highway users funded about $9.1 billion, or 96 percent, of highway expenditures. Additional 1981 highway outlays--included under other budget functions and funded from general funds--totaled more than $1.0 billion. Airway user fees funded about 42 percent of the $3.3 billion in federal expenditures for airports and airways. Inland waterway user charges funded less than 5 percent of the estimated $700 million spent for inland waterways. Full recovery of all federal costs (including those outside the transportation budget function) for highways, airways, and inland waterways would increase revenues by about $4.0 billion in 1987. Moreover, extending the user-charge principle to federal deep-draft navigation activities could result in additional revenues of about $1.75 billion in 1987 (assuming full recovery of costs). Certain services provided by the Federal Communications Commission, Securities and Exchange Commission, Commodity Futures Trading Commission, and the Department of Commerce could also be subject to full cost recovery.

Applying this strategy to energy and natural resources (see Chapter V) could increase entrance fees to national parks, charge the utility industry the full cost for uranium enrichment and nuclear waste disposal, and even impose a new fee on refined oil products to finance the purchase of oil for the Strategic Petroleum Reserve. Similarly, the federal government could charge market prices for sales of irrigation water and for grazing rights on federal lands. Raising the current energy and resources fees to full-cost recovery or market prices would increase revenues and/or offsetting receipts by about $4.4 billion in 1987. The application of this strategy to all transportation, energy, and natural resource areas would increase revenues and offsetting receipts by about $10.0 billion in 1987.

Reduce Subsidies to Private-Sector Activities: The federal government now subsidizes many private-sector activities either